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IN THE

Supreme Court of the United States

October Term, 1971.

No. 71-1425

IN THE MATTER OF
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor.

CENTRAL PENN NATIONAL BANK,
FIRST NATIONAL BANK OF MARYLAND,
FIRST WISCONSIN NATIONAL BANK OF
MILWAUKEE, WISCONSIN,
and
NATIONAL BANK OF DETROIT,
Petitioners,

v.

TRUSTEES OF THE PROPERTY OF THE
PENN CENTRAL TRANSPORTATION COMPANY,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1971.

No.

IN THE MATTER OF
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor,

CENTRAL PENN NATIONAL BANK,
FIRST NATIONAL BANK OF MARYLAND,
FIRST WISCONSIN NATIONAL BANK OF
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Petitioners,

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TRUSTEES OF THE PROPERTY OF THE
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Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

The petitioners, Central Penn National Bank, First National Bank of Maryland, First Wisconsin National Bank of Milwaukee, Wisconsin, and National Bank of

Detroit ("the petitioners"), respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit ("the Court of Appeals") entered in this proceeding on December 23, 1971 and its opinion entered on December 23, 1971, as amended on January 18, 1972.

OPINIONS BELOW.

The opinion, as amended, of the Court of Appeals is reported at 453 F. 2d 520 (3rd Cir. 1972), and appears in the Appendix to this petition. The Opinion and Order of the United States District Court for the Eastern District of Pennsylvania ("the reorganization court"), entered in these proceedings on August 5, 1970, is reported at 315 F. Supp. 1281 (E. D. Pa. 1970), and appears in the Appendix to this petition.

JURISDICTION.

The judgment of the Court of Appeals was entered on December 23, 1971, and this petition was timely filed within the period permitted for such filing by the Order entered March 13, 1972, by Mr. Justice Brennan of this Court, extending the time for such filing to and including May 1, 1972. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED.

1. Did the Court of Appeals err in holding that the reorganization court, under Section 77 of the Bankruptcy Act, had summary jurisdiction to enforce debtor's choses in action against petitioners, i.e. its claims to withdraw funds deposited with petitioners prior to reorganization in commercial bank accounts?

2. Did the Court of Appeals also err in holding that petitioners' set-offs of debtor's pre-petition indebtedness against debtor's pre-petition deposit balances did not constitute real and substantial adverse claims to property of the debtor, and therefore did not require adjudication in a plenary proceeding?

3. Did the Court of Appeals further err in holding that petitioners were not deprived of due process of law by the entry of a turn-over order at the contempt hearing afforded petitioners in this case?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED.

Fifth Amendment to the United States Constitution.

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

United States Code, Title 11 (Bankruptcy Act).

§ 2: Creation of Courts of Bankruptcy and Their Jurisdiction (Bankruptcy).

a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceeding under this Act, in vacation, in chamber, and during their respective terms, as they are now or may be hereafter held, to—

* * *

(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested

interests of the bankrupt's spouse in the property of any estate whenever, under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest; and where in a controversy arising in a proceeding under this Act an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy, by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or intended by order of court for the filing of an answer to the petition, motion or other pleading to which he is adverse, he shall be deemed to have consented to such jurisdiction;

§ 46: Jurisdiction of United States and State Courts. (Bankruptcy)

a. The United States district courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings under this Act, between receivers and trustees as such and adverse claimants, concerning the property acquired or claimed by the receivers or trustees, in the same manner and to the same extent as though such proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.

b. Suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been instituted, unless by consent of the defendant. . . .

§ 205: (Reorganization of Railroads Engaged in Interstate Commerce).

(a) Any railroad corporation may file a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization.

The petition shall be filed with the court in whose territorial jurisdiction the corporation, during preceding six months or the greater portion thereof, had had its principal executive or operating office, and a copy of the petition shall at the same time be filed with the Interstate Commerce Commission (hereinafter called the "Commission"). When any railroad, although engaged in interstate commerce, lies wholly within one State, the proceedings shall be brought in the United States district court for the district in which its principal operating office has been located during the preceding six months or the greater portion thereof. The petition shall be accompanied by payment to the clerk of a filing fee of $150. Upon the filing of such a petition, the judge shall enter an order either approving it as properly filed under this section, if satisfied that it complies with this section and has been filed in good faith, or dismissing it, if he is not so satisfied. If the petition is so approved, the court in which the order is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a court of the United States would have had if it had appointed a receiver in equity of the property of the debtor for any purpose. Process of the court shall extend to and be valid when served in any judicial district. The Supreme Court of the United States shall promulgate rules relating to the service of process outside of the district in which the proceeding is pending, and any other rules which it may deem advisable in order to aid district courts and courts of appeal in exercising the jurisdiction herein conferred upon them. The railroad corporation shall be referred to in the proceedings as a "debtor".

§ 108: Set-Offs and Counterclaims. (Bankruptcy)

a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

§ 205: (Reorganization of Railroads Engaged in Interstate Commerce).

(1) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication has been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed.

STATEMENT OF THE CASE.

On Sunday, June 21, 1970, the debtor filed a petition for reorganization under Section 77 of the Bankruptcy Act, 11 U. S. C. § 205(a), in the reorganization court, which on the same date approved the petition by the issuance of *ex parte* Order No. 1 (A. 2).

As of that date, the debtor maintained deposit balances in ordinary commercial accounts with the petitioners aggregating $3,162,000 and was also indebted to the petitioners under certain loan agreements. In addition, the debtor had also entered into a compensating balance arrangement with National Bank of Detroit which required the debtor to maintain deposit balances at a specified level, as security for the debtor's indebtedness. The debtor's outstanding indebtedness to each petitioner substantially exceeded the debtor's deposit balance with that petitioner. In each case, the instruments of indebtedness provided that, upon the filing of a petition for reorganization by the debtor, all such indebtedness immediately became due and payable (A. 14-15).

On the following business day, Monday, June 22, 1970, petitioners set off the debtor's pre-petition deposit balances against the debtor's pre-petition indebtedness to them, prior to receipt by the petitioners of notice that Order No. 1 contained provisions[1] enjoining all banks from setting-off

1. "9. All persons and all firms and corporations, whatsoever and wheresoever situated, located or domiciled, hereby are restrained and enjoined from interfering with, seizing . . . or in any manner whatsoever disturbing any portion of the . . . deposit balances, . . . belonging to . . . the Debtor. . . ." (Entered June 21, 1970)

"10. All persons, firms and corporations . . . holding for the account of the Debtor deposit balances or credits be and each of them hereby are restrained and enjoined . . . from offsetting the same, or any thereof, against any obligation of the Debtor, until further order of this Court." (Entered June 21, 1970)

"7. Depositories of Debtor's funds be and each of them hereby is authorized to honor all checks, drafts and vouchers drawn by

the deposit balances of the debtor, with the force and effect of requiring all banks to turn over the funds represented by such pre-petition deposit balances, by honoring all checks drawn thereon (A. 14-15).

The petitioners declined to restore the deposit balances which had been set off, contending that the reorganization court lacked summary jurisdiction to issue such a directive, and that such a directive could properly be issued, if at all, only after successful, separate plenary proceedings by the trustees of the debtor against each of the petitioners in courts of competent jurisdiction, as contemplated by the long-standing decisions of this Court and other Courts of Appeal (A. 15-16).

Upon petition by the debtor, the reorganization court, on July 14, 1970, ordered the petitioners [2] to show cause why they should not be held in contempt of Order No. 1 prohibiting such set-offs, and why they should not promptly comply with its turn-over provisions, by honoring checks drawn against the debtor's pre-petition deposit balances.

On July 23, 1970, a hearing was held on the debtor's petition to show cause. The reorganization court described the hearing as "abbreviated", as being "directed prin-

1. (Cont'd.)

Debtor against its account or accounts and to carry on similar banking transactions with the Debtor without regard to the fact that the petition of the Debtor heretofore filed under Section 77 of the Acts of Congress relating to bankruptcy has been approved by this Court, without regard to any other provision of this Order; provided, however, that the honor pursuant to this Order by any depository of checks, drafts or vouchers drawn by the Penn Central Transportation Company prior to the filing of the petition herein (or drawn by the Debtor in possession thereafter) shall be without prejudice to any claim of set-off and/or any claim priority by such depository". (Originally entered June 21, 1970, but finally amended, as above, by *ex parte* Orders Nos. 2, 3, and 4 entered June 22, 23, and 24 respectively) (A. 13-15).

2. The order to show cause was directed to nine banks, including the four petitioners and five other banks, which, for reasons not relevant here, did not join in this petition (A. 14).

cipally at the underlying legal issue" of contempt, and as having "the most cluttered, confused record that [it had] ever run across."

At the hearing, the petitioners filed written answers to the petition, supported by detailed affidavits [3] and legal memoranda, and presented oral argument contending (a) that the reorganization court merely had threshold summary jurisdiction to determine whether the petitioners' set-offs constituted real and substantial adverse claims to the debtor's deposit balances, (b) that the petitioners' set-offs clearly did constitute real and substantial adverse claims, (c) that, accordingly, the reorganization court lacked summary jurisdiction to adjudicate the merits of petitioners' adverse claims, let alone to enter a turn-over order, and (d) that such a turn-over order if entered at a contempt proceeding would violate the due process rights of the petitioners guaranteed by the Fifth Amendment to the United States Constitution.

On August 5, 1970, the reorganization court entered Order No. 24, directing the petitioners, under penalty of contempt, to comply with the turn-over portions of Order No. 1, but also held that it lacked summary jurisdiction to direct another bank, National City Bank of Cleveland, to turn over funds which that bank had set off on the day preceding the filing of the debtor's petition for reorganization (A. 19-20).

On August 11, 1970, petitioners, under protest, but pursuant to written stipulation with the trustees of the debtor, complied with Order No. 24 and subsequently perfected timely appeals from Order No. 24 to the Court of Appeals (A. 3).

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3. Although given an opportunity to do so, the debtor did not dispute the contents of the petitioners' answers and supporting affidavits.

On December 23, 1971, the Court of Appeals entered a judgment affirming Order No. 24 of the reorganization court, and on the same date filed its opinion, later amended on January 18, 1972 (A. 12).

Petitioners thereafter timely filed a petition with this Court for a writ of certiorari to review the decision of the Court of Appeals.

REASONS FOR GRANTING THE WRIT.

1. The Decision of the Court of Appeals Represents a Sweeping Enlargement of the Summary Jurisdiction of Bankruptcy Courts in General and of Railroad Reorganization Courts in Particular, in Conflict With the Decisions of This Court and Other Courts of Appeal, Which Have Uniformly Held That:

(A) Although Bankruptcy Courts Have Summary Jurisdiction to Determine That a Debtor's Chose in Action Against a Bank Arising From a Pre-Petition Deposit Balance Is "Property" of a Debtor Within the Meaning of the Bankruptcy Act, Such Courts, Absent the Consent of the Bank, Lack Jurisdiction to Enforce Such Chose in a Summary Proceeding, and A Fortiori Lack Jurisdiction to Adjudicate in a Summary Proceeding the Merits of a Real and Substantial Adverse Claim Against the Chose, Such as a Claim of Set-Off by the Depository Bank.

(B) In Railroad Reorganization Proceedings, as in Bankruptcy Proceedings Generally, Set-Offs by a Depository Bank of the Debtor's Pre-Petition Indebtedness Against the Debtor's Pre-Petition Deposit Balances Constitute Real and Substantial Adverse Claims to the Debtor's Chose, Whether Such Adverse Claims Are Asserted by Pre-Petition or Post-Petition Set-Offs.

Funds deposited prior to bankruptcy in ordinary commercial bank accounts, are not "property" of the debtor within the meaning of the Bankruptcy Act, but are property of the depository banks. However, the claim to withdraw such funds is a chose in action which is "property" of the debtor. This distinction has been uniformly recognized by other Courts of Appeal and by this Court.

In *Killoren v. First National Bank in St. Louis,* 127 F. 2d 537 (8th Cir. 1942), a bankruptcy proceeding, the Eighth Circuit Court of Appeals stated:

> "The checks and the funds which they represented were the checks and the funds of the [depositor] up to the time they were deposited in the bank. Upon being deposited, they belonged to the bank and the bank became indebted to the [depositor] therefor. The deposit balance was in effect a debt owing by the bank to the [depositor]." (at page 541)

In a similar context, involving the equity receivership of a bank, the Seventh Circuit Court of Appeals stated in *Cicero State Bank v. Crowley,* 115 F. 2d 1022 (7th Cir. 1940):

> "We think the law is well settled that when money is deposited in a bank, title to such money passes to the bank. The bank becomes the debtor of the depositor to the extent of the deposit, and to that extent the depositor becomes the creditor of the bank. Such deposit then constitutes a part of the assets of the bank . . ." (at page 1023)

The Eighth Circuit Court of Appeals in *Killoren* cited, in support of its decision and reasoning, the decisions of this Court in *New York County Bank v. Massey,* 192 U. S. 138 (1904), *Bank of the Republic v. Millard,* 10 Wall. 152 (1869), and *Davis v. Elmira Savings Bank,* 161 U. S. 275 (1896). See also, *Anderson National Bank v. Luckett,* 321 U. S. 233 (1944).

But to concede, as petitioners do, that debtor's claim to withdraw pre-petition deposit balances constitutes "property" of the debtor within the meaning of Section 77(a) of the Bankruptcy Act, over which railroad reorganization courts may exercise summary jurisdiction to deter-

mine the debtor's ownership of the chose, is not to concede that such courts may enforce such chose in a summary proceeding, without the consent of the obligor of the chose. Indeed, except for the holding of the Court of Appeals in this case, it has been the uniform holding of other Courts that the enforcement of the chose must be by plenary proceeding in a court of competent jurisdiction.

In *Bovay v. H. M. Byllesby & Co.*, 88 F. 2d 990 (5th Cir. 1937), the court held:

> ". . . It is conceded that a chose in action which belongs to the debtor is an intangible asset, subject to the control of the bankruptcy court, but the title to the thing is not sufficient to confer jurisdiction over the person of the defendants owing the money who reside in another district and are beyond the ordinary processes of the court." (at page 992)

Moreover, it has been specifically held that a debtor's claim against a bank arising out of a bank deposit does not give a reorganization court jurisdiction over the depository bank. In *In re Italian Cook Oil Corporation*, 91 F. Supp. 72 (D. N. J. 1950), the court held:

> "It is our opinion that the bank deposit was nothing more than a chose in action, a right to demand and enforce payment of a debt. The specific funds lost their character as tangible property upon their deposit by the Debtor; the relationship between the Debtor and the Bank then became that of creditor and debtor. (at page 74)
>
> * * *
>
> "The present petition has for its object not the recovery of specific tangible property in the possession of the Bank but the enforcement of a claim against the Bank . . . The reasons assigned by the Bank for its refusal to pay the full amount of the deposit may be

without merit . . . but it nevertheless has a right to insist that the issues of the controversy be decided by a court of competent jurisdiction. The Bank cannot be compelled to submit to the summary jurisdiction of a court of bankruptcy.

"It is our conclusion that this court, as a court of bankruptcy, is without jurisdiction . . ." (at page 75)

In reaching its decision, the court in *Italian Cook, supra*, relied upon *In re Standard Gas & Electric Co.*, 119 F. 2d 658 (3rd Cir. 1941) and *In re Roman*, 23 F. 2d 556 (2nd Cir. 1928). In the latter, Judge Learned Hand stated that a bankruptcy court could not summarily force an adverse party to pay a claim for money (i.e., a chose in action) made against it by a party in bankruptcy because such action:

". . . ignores the distinction between the obligation to perform and the consequences of performance. *It would not be permissible to collect even a bank deposit due a bankrupt by these means.* So far as possession can be imputed to such property at all, it is confined to the rights of the bankrupt to enforce the promise. *The trustee must proceed as the bankrupt must have proceeded, in a court having competent jurisdiction in such causes . . . Where procedural questions are at stake, such differences go to the essence. . . .*" (at page 558) (Emphasis added.)

In the present case, the Court of Appeals affirmed the issuance by the reorganization court of a turn-over order, entered summarily over objection by petitioners, enforcing the debtor's choses in action against petitioners by directing petitioners to turn over the funds represented by the debtor's pre-petition deposit balances. Such decision by

the Court of Appeals is in conflict with the cited decisions of the Courts of Appeals of the Second, Fifth, Seventh and Eighth Circuits and of this Court.

Since no bankruptcy court has summary jurisdiction to enforce, collect or adjudicate the merits of a debtor's chose in action, absent consent by the obligor of the chose, *a fortiori* the bankruptcy courts lack summary jurisdiction to enforce such choses when real and substantial adverse claims are asserted with respect thereto.

This Court stated in *Harrison v. Chamberlin*, 271 U. S. 191 (1926), a bankruptcy proceeding:

> "It is well settled that a court of bankruptcy is without jurisdiction to adjudicate in a summary proceeding a controversy, in reference to property held adversely to the bankruptcy estate, without the consent of the adverse claimant; but resort must be had by the trustee to a plenary suit [cases omitted] . . . ." (at page 193)

This Court had earlier enunciated the same principles in *May v. Henderson*, 268 U. S. 111 (1925), and repeated them in *Harris v. Avery Brundage Co.*, 305 U. S. 160 (1938), both bankruptcy proceedings.

Until the present decision by the Court of Appeals, all Courts of Appeal, including this Court of Appeals, uniformerly recognized the *Harrison* rule, not only in bankruptcy proceedings: *In re Roman*, 23 F. 2d 556 (2nd Cir. 1928); *In re Indiana Flooring Co.*, 62 F. 2d 763 (2d Cir. 1933) *cert. den.* 290 U. S. 627 (1933), but also in corporate reorganization proceedings: *Bovay v. H. M. Byllesby & Co.*, 88 F. 2d 990 (5th Cir. 1937); *First National Bank in Houston v. Lake*, 199 F. 2d 524 (4th Cir. 1952); *In re Standard Gas & Electric Co.*, 119 F. 2d 658 (3rd Cir. 1941); *Susquehanna Chemical Corp. v. Producers Bank & Trust Co.*, 174 F. 2d 783 (3rd Cir. 1949), and in railroad reorgani-

zation proceedings: *In re Chicago & N. W. Ry. Co.*, 86 F. 2d 508 (7th Cir. 1936); *Thompson v. Terminal Shares*, 104 F. 2d 1 (8th Cir. 1939).

The following guidelines have been established by this Court and other Courts of Appeal for deciding the threshold question of whether or not an adverse claim is merely colorable and not real and substantial. A claim is "merely colorable" if it is "on its face made in bad faith and without any legal justification." *May v. Henderson, supra,* at page 119. A finding that a claim is merely colorable must be based upon "facts which no fair mind can dispute." *In re Indiana Flooring Co., supra,* at page 764. A reorganization court should not determine that an adverse claim is merely colorable unless it gives "due consideration [to] existing law." *In re Meiselman*, 105 F. 2d 995, 998 (2nd Cir. 1939).

And conversely, in *Harrison v. Chamberlin, supra,* this Court held:

> "[W]e are of [the] opinion that [an adverse claim] is to be deemed of a substantial character when the claimant's contention 'discloses a contested matter of right, involving some fair doubt and reasonable room for controversy', ... in matters either of fact or law; and is not to be held merely colorable unless the preliminary inquiry shows that it is so unsubstantial and obviously insufficient, either in fact or law, as to be plainly without color of merit and a mere pretense." (at page 195)

Other Courts of Appeal have uniformly held that the adverse claim of set-off asserted by a depository bank to the debtor's deposit balances in an ordinary commercial bank account satisfies the foregoing criteria and constitutes a real and substantial, and not merely a colorable, adverse

claim. See: *First National Bank of Thomasville, Ga. v. Hopkins*, 199 Fed. 873 (5th Cir. 1912); *Shortridge v. Utah Savings & Trust Co.*, 40 F. 2d 328 (10th Cir. 1930) (both bankruptcy proceedings), and *In re Chicago & N. W. Ry. Co.*, 86 F. 2d 508 (7th Cir. 1936) (a railroad reorganization proceeding).

Nevertheless, in the present case, the reorganization court flatly stated:

> "The power of the bankruptcy court to proceed summarily in this situation to adjudicate the merits of the banks' post-petitioners set-offs cannot be doubted." (A. 17)

The reorganization court cited no bank set-off case in support of its conclusion. The Court of Appeals affirmed, without discussion of the issue except for its citation of the decision of this Court in *May v. Henderson, supra.* As demonstrated above, the decision of this Court in *May v. Henderson* supports the contentions of the petitioners and not the holding of the Court of Appeals.

The Court of Appeals attempted to justify its departure from the decisions of other Circuit Courts of Appeal by advancing three new, and alternative theories:

First, the Court of Appeals attempted to distinguish between pre-petition set-offs, which it regarded as real and substantial adverse claims, and post-petition set-offs, which it regarded as merely colorable adverse claims. This distinction by the Court of Appeals is evident from the fact that it did not disturb the reorganization court's ruling that it lacked summary jurisdiction over the pre-petition set-off by National City Bank of Cleveland, but possessed summary jurisdiction over the post-petition set-off by petitioners (A. 19).

However, no other Court of Appeals has held that the assertion of a set-off of deposit balances prior to the filing

of the petition in bankruptcy was essential to, or that the assertion of a set-off of deposit balances after the filing of a petition in bankruptcy was fatal to, a determination that the set-off constituted a real and substantial adverse claim. See, e.g., *In re Chicago & N. W. Ry. Co.*, 86 F. 2d 508 (7th Cir. 1936), a railroad reorganization case; *In re Eakin*, 154 F. 2d 717 (2nd Cir. 1946), a bankruptcy case; *Shortridge v. Utah Savings & Trust Co.*, 40 F. 2d 328 (10th Cir. 1930), a bankruptcy case; *First National Bank of Thomasville, Ga. v. Hopkins*, 199 Fed. 873 (5th Cir. 1912), a bankruptcy case. Indeed, see: *Susquehanna Chemical Corp. v. Producers Bank & Trust Co.*, 174 F. 2d 783 (3rd Cir. 1949), a corporate reorganization case.

More importantly, however, the decision of the Court of Appeals, if grounded on this first distinction, is in direct conflict with the decision of this Court in *Lowden v. Northwestern National Bank & Trust Co.*, 298 U. S. 160 (1936), dealing with a bank set-off effected seven days after the filing of a railroad reorganization petition. If the bank's post-petition set-off in *Lowden* had been too late to qualify as a real and substantial adverse claim, this Court would logically have declared the third question certified in that case (i.e. the criteria to be weighed in determining whether a post-petition set-off should ultimately be allowed) to be moot, rather than premature, or would have answered it in the negative, as a matter of law. At the very least, this Court would have included the timing of assertion of the set-off, i.e. whether before or after the filing of the reorganization petition, among the important factors to be weighed in determining whether a set-off should ultimately be allowed in a railroad reorganization proceeding.

Second, the Court of Appeals attempted to justify its departure from the holdings of other Courts of Appeal by establishing a new and additional criterion for determining whether a set-off constitutes a real and substantial adverse

claim, namely, whether there is a "bona fide dispute concerning the bankrupt's entitlement" [to the chose, rather than a defense to the chose] "at the time of bankruptcy," stating that:

> "Here the dispute is not about the existence or amount of any bank's indebtedness to the railroad on June 21, 1970 when reorganization proceedings were instituted, but rather whether the banks are privileged during the pendency or reorganization, to elect to satisfy their own claims against the railroad by self help through the remedial device of set-off." (A. 6)

The simple answer to the attempt to establish such a new criterion is to point out (a) that, not only has no other Court of Appeals made such a distinction or required that there be a dispute as to the debtor's "entitlement to", i.e. ownership of the chose at the moment of bankruptcy, and (b) if such a criterion were to be the proper test of whether a set-off constituted a real and substantial adverse claim, then none of the set-offs found to be real and substantial adverse claims by other Courts of Appeal would have qualified. See: *In re Eakin*, 154 F. 2d 717 (2nd Cir. 1946); *Shortridge v. Utah Savings & Trust Co.*, 40 F. 2d 328 (10th Cir. 1930); *First National Bank of Thomasville, Ga. v. Hopkins*, 199 Fed. 873 (5th Cir. 1912), and indeed, neither would the post-petition set-off presented to this Court in *Lowden v. Northwestern National Bank & Trust Co.*, 298 U. S. 160 (1936). Furthermore, the requirement that a set-off involve a dispute over the debtor's "entitlement" to the chose in action at the time of the filing of the bankruptcy petition, is incompatible with the concept of the assertion of post-petition set-offs under Section 68 of the Bankruptcy Act, 11 U. S. C. § 108(a), in all forms of bankruptcy proceedings.

Assuming, *arguendo,* that the Court of Appeals was correct in holding that a post-petition set-off could not qualify as a real and substantial adverse claim unless there existed, "at the time of the bankruptcy", a dispute between the debtor and petitioners with respect to "entitlement" to the chose itself, the record, ignored both by the reorganization court and the Court of Appeals, clearly discloses that such a dispute did exist between the debtor and one of the petitioners, National Bank of Detroit, by reason of the compensating balance arrangement existing "when the reorganization proceedings were instituted," the agreed intent and purpose of which was to deprive the debtor, prior to and during reorganization, of its right to withdraw the funds on demand, i.e. its "entitlement" to the chose.

Third, the reorganization court attempted to justify its departure from the holdings of courts in cases not arising under Section 77 of the Bankruptcy Act, by indicating that it regarded the summary jurisdiction of the bankruptcy courts in railroad reorganization proceedings as broader than in other forms of bankruptcy, including corporate reorganizations, by reason of "the overriding public interest in the continuation of rail transportation services" and "the absolute necessity of continuing the operation of trains." (A. 16). The Court of Appeals affirmed the holding and agreed with the reasoning of the reorganization court, stating that, in corporate reorganization

> ". . . the public interest in the survival of the enterprise is a less compelling consideration than in railroad reorganization . . ." (A. 4)

and that in railroad reorganizations

> ". . . the public interest is not merely a pawn to be sacrificed for the protection of a class . . . of claimants." (A. 4)

However, this Court has held, in the railroad reorganization proceeding of *Meyer v. Fleming*, 327 U. S. 161, 164 (1946), that the exclusive summary "jurisdiction granted the reorganization court by § 77(a) is that which bankruptcy courts have customarily possessed," citing with approval the railroad reorganization case of *Thompson v. Terminal Shares*, 104 F. 2d 1 (8th Cir. 1939), in which this Court denied certiorari, 308 U. S. 559 (1939). In *Thompson*, after a thorough review of the legislative history of summary jurisdiction in railroad reorganization proceedings, the Eighth Circuit held that:

> "From this legislative history, it appears that Congress, in amending Section 77, was certainly not conscious of any intent or purpose to substantially enlarge its previous grants of jurisdiction to the courts of bankruptcy with respect to the reorganization of railroads. *The intent and purpose was to make Section 77 in that regard substantially, if not completely, identical with Section 77B [governing corporate reorganization] so far as jurisdiction was concerned.* (at page 7)
>
> * * *
>
> ". . . Section 77 as amended in 1935 and Section 77B are *identical with respect to the jurisdiction of the bankruptcy courts*, except that under Section 77 the courts are expressly given the power to send process outside their districts . . . To our minds that provisions is more procedural than jurisdictional." (at page 8) (Emphasis added.)

A similar contention that the public interest in continued operation of the railroad warranted enlarged summary jurisdiction of the reorganization courts in railroad reorganization proceedings was also rejected by the Seventh Circuit Court of Appeals in *In re Chicago & N. W. Ry. Co.*, 86 F. 2d 508 (7th Cir. 1936).

For these reasons, the decision of the Court of Appeals (a) represents a fundamental misconception of the scope of summary jurisdiction of the bankruptcy courts in railroad reorganization proceedings and distorts the jurisdictional intent of Congress in enacting the railroad reorganization provisions of the Bankruptcy Act. In so doing, the decision of the Court of Appeals creates a direct conflict with the decisions of this Court in *Meyer v. Fleming* and the decisions of other Court of Appeal in railroad reorganization cases, and (b) misinterprets fundamental principles of bankruptcy law applicable in determining whether an adverse claim to "property" of the debtor is real and substantial, thereby expanding the summary jurisdiction of the bankruptcy courts, with ramifications applicable to all forms of bankruptcy proceedings, by imposing a new requirement for adverse claims of set-off which is impracticable and inequitable, and in conflict with the decisions of other Courts of Appeal and the decisions of this Court, particularly the landmark railroad reorganization decision of this Court in *Lowden v. Northwestern National Bank & Trust Co., supra.*

This Court alone can and should promptly resolve this conflict.

2. The Decision of the Court of Appeals, Affirming the Reorganization Court's Enforcement of an Ex Parte Turn-Over Order After an Abbreviated Contempt Hearing, Deprives Petitioners of a Plenary Hearing and Hence of the Due Process of Law Guaranteed by the Fifth Amendment to the United States Constitution, in Conflict With the Decisions of Other Courts of Appeal and With the Earlier Decision of This Court in Lowden v. Northwestern Bank and Trust Co.

The Court of Appeals stated that, "dispositive proceedings in the reorganization courts" must be "plenary

rather than summary" (A. 5). Petitioners agree with this axiomatic statement of law.

However, the Court of Appeals then attempted to justify its affirmance of the turn-over order of the reorganization court by the following alternate, but wholly inaccurate, reasoning. First, the Court of Appeals held that the proceedings resulting in turn-over Order No. 24 were not really dispositive of the ultimate set-off rights of petitioners since

> ". . . the reorganization court left open the question of what preferential treatment, if any, should be accorded [the petitioners] at a later stage of the reorganization . . ." (A. 6)

Second, the Court of Appeals reasoned, in the alternative, that even if Order No. 24 was, in fact, dispositive of the ultimate set-off rights of petitioners, the requirement of a "plenary" proceeding was nevertheless satisfied in this case, since the proceeding before the reorganization court lacked "no essential characteristic" of a plenary proceeding (A. 5).

The alternate reasoning of the Court of Appeals is in conflict with the decisions of other Courts of Appeals and the decision of this Court in *Lowden v. Northwestern Bank and Trust Co.*, 298 U. S. 160 (1936), for the following reasons:

First, the proceedings resulting in Order No. 24, requiring petitioners to turn-over the funds on deposit to the debtor were clearly "dispositive" of the ultimate set-off rights of petitioners.

In *Chase National Bank v. Lyford*, 147 F. 2d 273 (2d Cir. 1945), a railroad reorganization proceeding (in which the adverse claimant was held to have consented to the summary jurisdiction of the reorganization court for pur-

poses of adjudicating the merits of its post-petition set-off of deposit balances), the Second Circuit nevertheless held that the reorganization court could not enter a dispositive order (such as Order No. 24 in the present case), by directing the bank to turn over the funds represented by the deposit balances, until a full and proper hearing was held on the validity of the set-off, stating:

> "But to say that the court could properly consider the matter in a summary proceeding is not to say that, on the merits, the bank has no valid right of set-off . . . To the extent that the bankruptcy court order indicates otherwise it must be modified. . . . Pending that ascertainment and decision [on the ultimate merits of the bank's set-off] (which the court below in its discretion may postpone until it approves a plan of reorganization), *the bank is not to be required to pay, or set apart for payment to the trustee, any part of the bank balance.*" (at page 277) (Emphasis added.)

In short, the Second Circuit, in circumstances substantially identical to the present case, considered an order requiring the bank temporarily to pay over funds, or even temporarily to set aside funds for later payment to the trustee, as sufficiently "dispositive" of the bank's set-off rights and as sufficiently altering the *status quo* as to be impermissible until a plenary rather than a summary hearing had been held on the ultimate merits of the bank's post-petition set-off.

Second, a fundamental prerequisite for a dispositive order such as turn-over Order No. 24 is that the proceeding giving rise to the order must, in fact, be plenary *per se;* it is not sufficient that such proceedings possess the "essential characteristics" of a plenary proceeding.

In *Smith v. Belford*, 106 Fed. 658 (6th Cir. 1901), a bankruptcy proceeding, the Sixth Circuit held that a turn-over order entered *ex parte* against an adverse claimant violated due process of law, and, further, that a subsequent turn-over and contempt order which was based upon the *ex parte* order did not cure the due process defects of the original order, even though the subsequent order was entered after notice and hearing on an order to show cause. The Sixth Circuit held that the due process rights of the adverse claimant had been violated, because the adverse claimant:

> ". . . was not a party, and was, at least, entitled to an opportunity to be heard before [the first *ex parte* turn-over] order could be made. This is elementary. It is said that he had an opportunity to be heard later, and was heard. But the [first turn-over] order . . . was never released and the later [turn-over and contempt] order . . . was not an original order based upon a fresh petition and a hearing thereon, but was made in further execution of the [first *ex parte*] order . . . The only opportunity given him to be heard was upon an order to show cause why he should not be committed for contempt in not obeying the first [order]. . . . It is true that, in his answer to the order to show cause why he should not be committed for contempt, he alleged the facts on which his rights depended, but this was for the purpose of showing that the court had no lawful authority to order him to deliver the property to the trustee, for the reason that in such a state of facts it had no jurisdiction to entertain the proceedings." (at page 664)

In *In re Prima Co.*, 98 F. 2d 952 (7th Cir. 1938), a corporate reorganization proceeding, the Court of Appeals for

the Seventh Circuit made it clear that the character of a bankruptcy proceeding is to be determined by the character of the order resulting therefrom, so that a proceeding resulting in a turnover order (in that case, the setting aside of a voidable preference) is to be regarded as a summary proceeding, even though, while in progress, it possessed some or all of the characteristics of a plenary proceeding:

> "Appellees, however, contend that, although the proceeding was summary in character, it was in fact a plenary action, inasmuch as all the evidence which could have been heard in a plenary action was heard. Such fact we think is not always determinative of the question. It would seem that if the hearing were plenary, the judgment should have been plenary and not summary in its character. Here, however, there was a summary judgment requiring payment forthwith, and upon default appellants would be subject to penalty for contempt. Under these circumstances we think the proceedings were in fact summary rather than plenary." (at page 957)

Third, the proceedings in this case did not, in any event, possess the "essential characteristics" of a plenary proceeding.

What hearing was held in this case? Even the reorganization court characterized the hearing as "abbreviated" and "directed principally to the underlying legal issues" of contempt, and as having "the most cluttered, confused record that [it had] ever run across". The record plainly discloses that the reorganization court considered the hearing as affording petitioners merely the opportunity to avoid the imposition of sanctions for contempt. The reorganization court evidenced little interest in petitioners' argument on the issue of summary jurisdiction, let alone

any presentation, of the complexity and factual detail required by the decision of this Court in *Lowden*, on the ultimate merits of their post-petition set-offs. To regard the hearing afforded petitioners in this case as the "plenary" hearing acknowledged by the Court of Appeals to be required for a "dispositive proceeding" and to conclude, as did the Court of Appeals, that there had been a "full hearing and judicial consideration of all testimony and argument that these appellants chose to present" (A. 5), belies the record in this case.

The criteria for determining the propriety of post-petition set-offs in a railroad reorganization proceeding were clearly set forth by this Court in *Lowden v. Northwestern National Bank & Trust Co.*, 298 U. S. 160 (1936), in which this court stated that there should be inquire into:

> "... the value of the [debtor's] assets, the temporary or permanent character of the debtor's inability to pay its debts as they mature ... the probability of an understanding that the [debtor's obligation], though unmatured would be used to cancel the deposits, all the circumstances, in brief, that might affect the judgment of the chancellor in weighing the competing equities of the interested factions ..." (at pages 165-166)

By denying petitioners the hearing required by the decision of this Court in *Lowden*, the Court of Appeals, in addition to its improper exercise of summary jurisdiction, violated the fundamental due process rights guaranteed to the petitioners by the Fifth Amendment as enunciated by the decision of this Court in *Lowden* and the decisions of other Courts of Appeal.

This Court alone can and should promptly resolve this conflict.

3. Restatement by This Court of the Fundamental Principles Regarding the Applicability of Set-Off Under Section 68 to Railroad Reorganizations Under Section 77 Is Necessary and Timely Since This Issue Was Not Directly Decided by This Court in Lowden v. Northwestern National Bank & Trust Co. and Since the Decision of the Court of Appeals Is in Conflict With the Clear Negative Import of This Court's Decision in Lowden and the Later Decisions of Other Courts of Appeal, and Ignores the Criteria Established by This Court in Lowden for the Ultimate Determination of the Validity of Set-Offs in Railroad Reorganization Proceedings.

The Court of Appeals erroneously decided that the reorganization court had summary jurisdiction to determine the ultimate merits of a controversy in which the petitioners asserted real and substantial adverse claims in the form of post-petition set-offs of the debtor's pre-petition deposit balances. Moreover, the Court of Appeals compounded its error by further determining, in effect, that set-offs permitted under Section 68 of the Bankruptcy Act are impermissible *per se* in railroad reorganization proceedings.

Initially, the reorganization court stated:

> ". . . (I)t is inconceivable that Congress intended that a railroad under Section 77 reorganization should be deprived of the use of its cash, by the very act of filing the reorganization petition. If the respondent banks are correct in their contention that this Court's Order No. 1 was invalid, no railroad could possibly reorganize under Section 77." (A. 18)

In affirming, the Court of Appeals stated:

> "The decision [of the reorganization court] was grounded on equitable considerations inherent in the

administration of the statutory scheme of rail reorganization." (A. 6)

In *Lowden v. Northwestern National Bank & Trust Co.*, 298 U. S. 160 (1936), this Court considered the following questions:

> "Question 1. Does the right of set-off recognized by section 68(a) of the Bankruptcy Act apply to reorganization proceedings under section 77 of that act?
>
> "Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set-off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?
>
> "Question No. 3. If the first and second questions be answered in the affirmative, may the United States District Court, for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of set-off recognize and establish as a proper set-off by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?" (at page 162)

The jurisdictional question presented to the Courts of Appeals below was identical to the first and third questions presented to but not directly answered by this Court in

Lowden. The importance of these questions to the rights of the petitioners and to the future course of these proceedings involving the nation's largest railroad urgently require that this Court now answer these questions. Otherwise, the reasoning employed by the Court of Appeals will warrant automatic denial of the right of post-petition set-off in all railroad reorganization, and indeed in most if not all corporate reorganization proceedings as well, without review of such reasoning by this Court.

Although the jurisdictional question raised in this case was not directly answered in *Lowden*, the negative import of the decision of this Court in *Lowden* and the subsequent decisions of other Courts of Appeal have made it clear that the ultimate validity and allowability of Section 68 set-offs in railroad reorganization proceedings must be decided on a case-by-case basis, after a balancing of all relevant factors. In short, the decisions of this Court and other Courts of Appeal have rejected the *a priori* notion of the Court of Appeals that post-petition set-offs are automatically proscribed in railroad reorganization proceedings.

Mr. Justice Cardozo, speaking for this Court in *Lowden*, stated:

> "A court of equity in allowing or rejecting set-off will not be guilty of that fallacy [adjudication of the right of set-off in the abstract]. To know the justice of the particular case, one must know the case in its particulars. . . . *When all the facts are known, they may be found to offer no excuse for a departure from the rule in bankruptcy* which, as indicated already, is generally, even if not always, the rule in equity as well. They may point, on the other hand, to the need for an exception, or may even lead to a decree in the nature of a compromise, the moneys being paid into the registry

of the court to abide its future action. *A decision balancing the equities must await the exposure of a concrete situation with all its qualifying incidents.* (at pages 165-166) (Emphasis added.)

In *In re Chicago & N. W. Ry. Co.*, 86 F. 2d 508, 509 (7th Cir. 1936), a railroad reorganization proceeding, the Seventh Circuit Court of Appeals stated that "there are fact issues which affect the legal questions" and held that the validity of the asserted set-off should be determined in a plenary proceeding, thereby holding, *a fortiori*, that Section 68 is not *per se* inapplicable under Section 77. Indeed, in *Central Railroad Company of New Jersey*, 273 F. Supp. 282, 287 (D. N. J. 1967), *aff'd.* 392 F. 2d 589 (3rd Cir. 1968), a railroad reorganization case, the lower court stated "(t)he right to a set-off depends on the facts of each case."

The decision of the Court of Appeals, predicated not on the factual record in this case (there is no adequate factual record here by *Lowden* standards) but upon the misconception of the *a priori* inapplicability of Section 68 of the Bankruptcy Act to railroad reorganization proceedings, presents a clear conflict with the case-by-case interpretation of the applicability of set-offs in railroad reorganization proceedings endorsed by other Courts of Appeals. Indeed, the "compensating balance" arrangement between the National Bank of Detroit and the debtor was a "competing equity" of the nature that *Lowden* teaches should be examined in shaping a decree. Neither the reorganization court nor the Court of appeals gave any indication that it had weighed this equity, although, in addition to *Lowden*, such a consideration was specifically enumerated as significant by the Second Circuit Court of Appeals in *Tyler v. Marine Midland Trust Co. of New York*, 127 F. 2d 927 (2nd Cir. 1942), and indeed by the Court of

Appeals below in the earlier case of *Susquehanna Chemical Corporation v. Producers Bank & Trust Co.*, 174 F. 2d 783 (3rd Cir. 1949).

This is but another example of the disregard by the Court of Appeals of the prior decision of this Court in *Lowden* and of a conflict among the Courts of Appeal, which this Court alone can and should promptly resolve.

CONCLUSION.

This case involves a dispute between several major banks and the trustees in reorganization of the nation's largest railroad over entitlement to several million dollars of the debtor's deposit balances

In deciding adversely to the petitioners, the Court of Appeals has effected a sweeping enlargement of the summary jurisdiction of railroad reorganization courts in particular, and of the bankruptcy courts in general.

In addition, the decision of the Court of Appeals has already been relied upon and can be expected to be relied upon by the reorganization court in rulings of major significance in the reorganization proceedings of this debtor and establishes a precedent for significant rulings in all future railroad reorganization proceedings. The reasoning of the Court of Appeals would logically warrant similar decisions on the vital questions of summary jurisdiction, "property" of the debtor, and applicability of the provisions of Section 68 to all corporate reorganizations in particular, and to other forms of bankruptcy proceedings in general.

For the reasons set forth in this petition, the decision of the Court of Appeals presents a conflict with the decisions of this Court and of other Courts of Appeals, which this Court should promptly resolve.

Petitioners respectfully urge this Court to issue a writ of certiorari to review the judgment and opinion, as amended, of the Court of Appeals.

Respectfully submitted,

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May 1, 1972.

SUPREME COURT, U.S.
FILED
MAY 1 1972
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1971.

No. 71-1425

IN THE MATTER OF
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor.

CENTRAL PENN NATIONAL BANK,
FIRST NATIONAL BANK OF MARYLAND,
FIRST WISCONSIN NATIONAL BANK OF
MILWAUKEE, WISCONSIN,
and
NATIONAL BANK OF DETROIT,
Petitioners,

v.

TRUSTEES OF THE PROPERTY OF THE
PENN CENTRAL TRANSPORTATION COMPANY,
Respondent.

APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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Appendix.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 19,340 to 19,346

In the Matter of PENN CENTRAL
TRANSPORTATION COMPANY,

Debtor

FIRST WISCONSIN NATIONAL BANK
OF MILWAUKEE, WISCONSIN,

Appellant in No. 19,340

MARINE MIDLAND GRACE TRUST
COMPANY OF NEW YORK,

Appellant in No. 19,341

NATIONAL BANK OF DETROIT,

Appellant in No. 19,342

LINCOLN ROCHESTER TRUST COMPANY,
ROCHESTER, NEW YORK,

Appellant in No. 19,343

CENTRAL PENN NATIONAL BANK,
PHILADELPHIA, PENNSYLVANIA,

Appellant in No. 19,344

CITIZENS FIDELITY BANK & TRUST
COMPANY, LOUISVILLE, KENTUCKY,

Appellant in No. 19,345

FIRST NATIONAL BANK OF MARYLAND,
BALTIMORE, MARYLAND

Appellant in No. 19,346

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Argued September 28, 1971

Before SEITZ, *Chief Judge;* and HASTIE, *Circuit Judge;* and HERMAN, *District Judge*

OPINION OF THE COURT

(Filed December 23, 1971)

HASTIE, *Circuit Judge.*

A proceeding for the reorganization of Penn Central Transportation Company, a railroad corporation, under section 77 of the Bankruptcy Act, 11 U. S. C. § 205, was initiated by an order of June 21, 1970, wherein the District Court for the Eastern District of Pennsylvania approved the railroad's petition for reorganization and made various provisions concerning the continuation of the debtor's business and the operation of the railroad.

Paragraph 10 of the order reads in part as follows:

> "All persons, firms and corporations, . . . holding for the account of the Debtor deposit balances or credits be and each of them hereby are restrained and enjoined . . . from off-setting the same, or any thereof, against any obligation of the Debtor, until further order of this Court."

Paragraph 7 of the order, as amended on June 23, 1971, authorizes depositories of the debtor's funds to continue to honor the debtor's checks and drafts against its bank accounts, provided that such action "shall be without prejudice to any claim of set-off and/or any claim of priority by such depositor."

The debtor maintained bank accounts aggregating millions of dollars in some 142 banks in various places and drew on these accounts to meet payrolls and other essential

expenses of current operations. The present appellants are such banks. After the reorganization order of June 21 had been entered, each of the appellants set off the balance in the debtor's bank account against amounts the debtor owed it.

The reorganization court then required the appellants to show cause why they should not honor the debtor's withdrawals and also be adjudged in contempt of the judicial prohibition of set-off. After a hearing and the consideration of evidence the court particularly ordered each of the appellants to restore to the account of the debtor "all balances as the same existed on June 21, 1970" and to permit withdrawals in normal course to the full extent of such restored balances. There was no adjudication of contempt. The appellants complied with this order under protest and noticed and perfected the present appeals from it.

The appellants contend that prohibition of set-off of the debtor's bank accounts was beyond the jurisdiction of the reorganization court and could lawfully be accomplished only in plenary proceedings in each of which a competent court of general jurisdiction should obtain personal jurisdiction over a depository bank.

Section 77 of the Bankruptcy Act provides that upon a district court's approval of a railroad petition for reorganization, ". . .the court in which the order is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a court of the United States would have had if it had appointed a receiver in equity of the property of the debtor for any purpose." 11 U. S. C. § 205(a). The bank accounts with which this appeal is concerned are

property of the debtor in the form of choses in action. The appellant banks, being both creditors and debtors of the railroad, are contending that the reorganization court, though vested by express provision of section 77 with ". . . all the powers . . . which a court of the United States would have had if it had appointed a receiver in equity of property of the debtor . . ." cannot lawfully exercise jurisdiction to the extent of restraining them from satisfying their claims against the debtor by set-off and from thus, through self help, eliminating or reducing the balances outstanding in the debtor's bank accounts, as this intangible property existed at the time the reorganization petition was approved.

Even in Chapter X corporate reorganizations, where normally the public interest in the survival of the enterprise is a less compelling consideration than in railroad reorganization, a reorganization court may exercise the power of an equity court administering a receivership to restrain creditors from selling the debtor's collateral or pledges, or from setting off the debtor's choses in action, to satisfy outstanding obligations. *Lowden v. Northwestern National Bank*, 1936, 298 U. S. 160; *Continental Illinois National Bank v. Chicago, R. I. & Pac. Ry.*, 1935, 294 U. S. 648; *Susquehanna Chemical Corp. v. Producers Bank & Trust Co.*, 3rd Cir. 1949, 174 F. 2d 783; *In re Cuyahoga Finance Co.*, 6th Cir. 1943, 136 F. 2d 18.[1] In an *a fortiori* situation where, as here, the debtor was a railroad in reorganization,[2] this court has approved an order of a

1. The cited cases recognize that section 68 of the Bankruptcy Act which sanctions set-off in ordinary bankruptcy is not controlling in corporate reorganizations. *See also In re Yale Express Systems, Inc.*, 2nd Cir. 1966, 362 F. 2d 111.

2. The Supreme Court recently has reminded us that in railroad organization ". . . the public interest is not merely a pawn to be sacrificed for the protection of a class . . ." of claimants. *See Penn-Central Merger Cases*, 1968, 389 U. S. 486, 511.

reorganization court prohibiting a bank from applying the procedure of set-off to a debtor's bank account. *In re Central R. R. Co. of N. J.*, 1968, 392 F. 2d 589, *aff'g. per curiam D. N. J.* 1967, 273 F. Supp. 282.

The appellants seek to distinguish some, if not all, of these cases on the ground that the dispositive proceedings in the reorganization courts were plenary rather than summary. It is true that, *ex necessitate rei,* the original order approving the present reorganization petition and restraining set-off until further order of the court was entered ex parte. But the order from which this appeal has been taken, restraining the appellants individually from utilizing the remedy of set-off as to particular accounts and obligations, was entered only after notice,[3] a full hearing and judicial consideration of all testimony and argument that these appellants chose to present. No essential characteristic of a plenary proceeding was lacking.

In these circumstances, the gravamen of the appellants' complaint is not that the proceeding lacked due process or plenary character but rather that the reorganization court undertook to interfere with their claimed right of set-off rather than leaving this disputed question to adjudication in an original suit in some court of general jurisdiction. We are asked to apply the concept, familiar to ordinary bankruptcy by force of section 23 of the Bankruptcy Act, 11 U. S. C. § 23, that when controversy exists whether the bankrupt or some other person owns property, the trustee must vindicate the bankrupt's claim in a separate action in a court of general jurisdiction. But this requirement applies only where there is a bona fide dispute concerning the bankrupt's entitlement at the time

3. Section 77(a) in its present form, 11 U. S. C. § 205(a), expressly provides that "[p]rocess of the [reorganization] court shall extend to and be valid when served in any judicial district."

of bankruptcy. *May v. Henderson*, 1925, 268 U. S. 111. Here, the dispute is not about the existence or amount of any bank's indebtedness to the railroad on June 21, 1970 when reorganization proceedings were instituted, but rather whether the banks are privileged during the pendency of reorganization, to elect to satisfy their own claims against the railroad by self help through the remedial device of set-off. Indeed, by claiming set-off the banks necessarily admit their obligations to the railroad and seek to discharge them in a manner other than by payment. The reorganization court has merely denied them resort to that remedy during reorganization. Its decision was grounded upon equitable considerations inherent in the administration of the statutory scheme of railroad reorganization. Indeed, the district court found that the continuation of the operation of the railroad, the basic purpose of reorganization, would have been frustrated if the 142 banks in which it maintained accounts aggregating millions of dollars were permitted to set-off these balances. It was neither necessary nor desirable to have that matter adjudicated in a court of general jurisdiction, for the dispute was within the area of special concern and competency of the reorganization court and it did not present any controversy about entitlement to property when reorganization began.

Finally, it is noteworthy that the reorganization court left open the question of what preferential treatment, if any, should be accorded the appellants at a later stage of the reorganization with reference to their claims which they have been prohibited from satisfying by set-off during the initial stage or reorganization. *Cf. In re New York, N. H. & H. Ry.*, 2nd Cir. 1945, 147 F. 2d 57, *cert. denied* 325 U. S. 884. Even secured creditors of a railroad must submit to the risk inherent in judicial suspension of

the rights they normally would have to enforce their liens against property of the debtor during the pendency of a reorganization proceeding. *New Haven Inclusion Cases*, 1970, 309 U. S. 392, 489-94.

The order from which these appeals have been taken will be affirmed.

SEITZ, *Chief Judge*, concurring.

The issue before us is whether the reorganization court had summary jurisdiction to order that appellants honor Penn Central's post-petition drafts on its accounts and to enjoin each appellant from setting off against the Company's deposits its respective outstanding loan balances. It is contended that by simultaneously permitting withdrawal and enjoining set-off pursuant to a summary proceeding the reorganization court effected a turnover of Penn Central's funds held by appellants in contravention of section 23 of the Bankruptcy Act, 11. U. S. C. 104.

Section 23 requires that adverse claims to property held other than by the debtor must be decided in a plenary proceeding by a court of general jurisdiction. It is for the reorganization court, however, to decide at the outset whether adverse claims in fact exist. *See* May v. Henderson, 268 U. S. 111, 115 (1925). The sole basis for the claims here asserted is the contractual right of set-off embodied in the various loan agreements existing between Penn Central and the appellants. The reorganization court determined, as it is permitted to do, that in the factual setting of this reorganization the right should not be recognized. *See* Lowden v. Northwestern Nat'l. Bk. & Trust Co., 84 F. 2d 847, *cert. denied* 299 U. S. 583 (1936). *See* generally 5 *Collier on Bankruptcy*, ¶ 77.10 and n. 6 (14th ed. 1970). This determination in effect eliminated appellants' adverse claims against Penn Central's deposits since appellants

do not contest the Company's right thereto in the absence of the right of set-off. *Compare* In re Standard Gas & Electric, 119 F. 2d 658, 662 (3rd Cir. 1941). Consequently, the reorganization court had summary jurisdiction to order appellants to honor the Company's drafts and to enjoin appellants' right of set-off.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

Nos. 19,340 to 19,346

In the Matter of
PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

FIRST WISCONSIN NATIONAL BANK
OF MILWAUKEE, WISCONSIN,
Appellant in No. 19,340

MARINE MIDLAND GRACE TRUST
COMPANY OF NEW YORK,
Appellant in No. 19,341

NATIONAL BANK OF DETROIT,
Appellant in No. 19,342

LINCOLN ROCHESTER TRUST COMPANY,
ROCHESTER, NEW YORK,
Appellant in No. 19,343

CENTRAL PENN NATIONAL BANK,
PHILADELPHIA, PENNSYLVANIA
Appellant in No. 19,344

CITIZENS FIDELITY BANK & TRUST
COMPANY, LOUISVILLE, KENTUCKY,
Appellant in No. 19,345

FIRST NATIONAL BANK OF MARYLAND,
BALTIMORE, MARYLAND,
Appellant in No. 19,346

Present: SEITZ, *Chief Judge;* and HASTIE, *Circuit Judge;* and HERMAN, *District Judge.*

ORDER AMENDING OPINION

The printed opinion in this case filed December 23, 1971 is hereby amended by striking the language "this court has approved an order of a reorganization court prohibiting a bank from applying the procedure of set-off to a debtor's bank account," as that language appears beginning at line 22 of page 4 of the opinion, and substituting the language "this court has approved an order of a reorganization court prohibiting another railroad from applying the procedure of set-off to obligations outstanding between it and the debtor."

BY THE COURT:

WILLIAM H. HASTIE
Circuit Judge

Dated: January 18, 1972

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

Nos. 19340 through 19346

In the Matter of:

PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

FIRST WISCONSIN NATIONAL BANK OF MILWAUKEE, WISCONSIN,
Appellant in No. 19,340

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,
Appellant in No. 19,341

NATIONAL BANK OF DETROIT,
Appellant in No. 19,342

LINCOLN ROCHESTER TRUST COMPANY, ROCHESTER, NEW YORK,
Appellant in No. 19,343

CENTRAL PENN NATIONAL BANK, PHILADELPHIA, PENNSYLVANIA,
Appellant in No. 19,344

CITIZENS FIDELITY BANK & TRUST COMPANY, LOUISVILLE, KENTUCKY,
Appellant in No. 19,345

FIRST NATIONAL BANK OF MARYLAND, BALTIMORE, MARYLAND,
Appellant in No. 19,346

(D. C. In Bankruptcy No. 70-347)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA.

Present: SEITZ, *Chief Judge* and HASTIE, *Circuit Judge* and HERMAN, *District Judge.*

JUDGMENT.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed August 5, 1970, be, and the same is hereby affirmed, with costs taxed against appellants.

ATTEST:

THOMAS P. QUINN

Clerk

December 23, 1971

IN THE

UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN PROCEEDINGS FOR THE REORGANIZATION OF A RAILROAD

CAUSE NO. 70-347

IN THE MATTER OF

PENN CENTRAL TRANSPORTATION COMPANY,
Debtor

OPINION

FULLAM, *J.* August 5, 1970

On June 21, 1970, this Court, per Kraft, J., entered an order approving the petition of the Penn Central Transportation Company for reorganization under section 77 of the Bankruptcy Act (11 U. S. C. § 205, et seq.). Paragraph 10 of the Order (Order No. 1) provided in part as follows:

> "10. All persons, firms and corporations . . . holding for the account of the debtor deposit balances . . . hereby are restrained and enjoined . . . from off-

> setting the same . . . against any obligation of the debtor, until further order of this Court."

The Order further provided, in paragraph 7, that such depositories of funds of the debtor were authorized to honor all checks, drafts and vouchers drawn by the debtor against its bank accounts, without regard to the fact that the reorganization petition had been filed and approved. By further orders entered on June 23 and 24, 1970, it was made clear that the honoring of checks and drafts would be without prejudice to any claim the banks might have to priority, by reason of any alleged right of setoff which would otherwise have existed, or otherwise.

When the reorganization petition was filed, the debtor had many millions of dollars on deposit in some 142 bank accounts scattered throughout the United States. Telegrams were sent to each of these 142 banks, advising them of the filing of the reorganization petition, its approval by the Court, and, specifically, the provisions of paragraphs 10 and 7 of the Court's Order.

Notwithstanding the foregoing facts, nine of the banks involved made bookkeeping entries which purported to set off the debtor's funds against various loans allegedly due the banks, and refused to honor checks drawn on such accounts. The total amount of these purported setoffs is in excess of $4,500,000.

On July 14, 1970, the debtor filed a verified petition and obtained an order, returnable July 23, 1970, directing the nine respondent banks to show cause why the Court should not adjudge them in contempt of the Order of June 21, 1970, and require them to honor forthwith the debtor's withdrawals to the full extent of the funds on deposit. The respondent banks, and the approximate amount retained by each, are as follows:

National City Bank of Cleveland, Ohio	$ 950,000
Citizens Fidelity Bank and Trust Company, Louisville, Kentucky	60,000
National Bank of Detroit, Michigan	1,000,000
Lincoln Rochester Trust Company, Rochester, New York	59,000
Marine Midland Grace Trust Company, New York City	206,000
Central Penn National Bank, Philadelphia, Pennsylvania	1,800,000
First National Bank of Maryland, Baltimore, Maryland	142,000
First Wisconsin National Bank of Milwaukee, Wisconsin	220,000
Central Trust Company of Cincinnati, Ohio	75,000

A hearing was held on July 23, 1970, and evidence and oral argument were presented.

It is conceded that, with one exception, all of the setoffs took place after the respondent banks had actual notice of the filing of the reorganization petition and its approval by the Court, although in several instances, the bookkeeping entries were made before receipt of the telegram which specifically advised of the contents of paragraphs 10 and 7 of the Order. In the case of National City Bank of Cleveland, Ohio, a substantial portion of the setoff occurred on June 20, 1970, before the debtor filed its reorganization petition; however, this bank entered a further setoff of some $27,000 on June 22, 1970, after actual notice of the filing and approval of the reorganization petition.

With respect to all of the post-petition setoffs, the respondent banks raise substantially similar arguments: it is

contended that the Order of June 21, 1970 was invalid because entered *ex parte;* that the Court was without jurisdiction to enjoin setoffs in a summary proceeding; that the banks' right of setoff under section 68 of the Bankruptcy Act (11 U. S. C. § 108) can be infringed, if at all, only after the issues are fully litigated in a plenary action. Some of the banks further contend that such plenary action can only be brought in the jurisdiction where the particular bank is located.

All of the respondents' contentions overlook the distinctions between ordinary bankruptcy proceedings and reorganization proceedings in general, and the further distinctions between a Chapter X reorganization proceeding and the special provisions of section 77 relating to railroad reorganizations. An ordinary bankruptcy is directed toward the liquidation of the debtor's business, and the distribution of the debtor's assets among its creditors. A Chapter X reorganization is directed toward the continuation of the debtor's business so that it may be restored to solvency, and its creditors ultimately satisfied. A railroad reorganization under section 77 of the Bankruptcy Act involves an additional element, the overriding public interest in the continuation of rail transportation services. *See In re Central Railroad Company of New Jersey,* 273 F. Supp. 282 (D. N. J. 1967) aff'd 392 F. 2d 589 (3rd Cir. 1968).

Even in an ordinary reorganization under Chapter X, the right of setoff referred to in section 68 of the Act is not automatic, but is available only if the bankruptcy court, in its discretion, determines that permitting the setoff would not frustrate the reorganization process. *Susquehanna Chemical Corp. v. Producers Bank and Trust Co.,* 174 F. 2d 783 (3rd Cir. 1949). Clearly, the banks' alleged rights of setoff cannot be regarded as automatic or paramount in a railroad reorganization, in view of the absolute necessity of continuing the operation of trains. *See Lowden v. North-Western National Bank and Trust Co.,* 298 U. S. 160 (1936).

It follows that the *ex parte* Order here involved did not deprive the respondents of any absolute legal right.

The power of the bankruptcy court to proceed summarily in this situation cannot be doubted. As long ago as *Continental Illinois National Bank and Trust Co. v. Chicago-Rock Island & Pacific Ry. Co.*, 294 U. S. 648 (1935), the Supreme Court held that such power is firmly established, on the basis of the inherent power of a court of equity to protect its jurisdiction, on the basis of the All Writs Statute, 28 U. S. C. § 1651, and on the basis of section 2(15) of the Bankruptcy Act itself (11 U. S. C. § 11(15)).

The Court's order in the present case did not adjudicate the substance of any claim by the banks. It merely restrained them from exercising the remedy of self-help. There is no suggestion that the debtor is actually bankrupt, or likely to become so. Indeed, it seems quite clear that the total value of the assets of the debtor far exceed its liabilities.

The respondent banks argue that this Court's Order No. 1, by enjoining setoffs and at the same time authorizing the honoring of checks, was equivalent to a turn-over order, and thus required plenary proceedings. In this respect, it is argued, the present case differs from the *Continental Bank* case, *supra*, where the summary disposition merely prevented the sale of collateral. From a narrow, conceptualistic viewpoint, this argument has some plausibility. Nevertheless, setting off bank deposits against demand promissory notes is certainly closely analogous to a sale of collateral; and in the declining market of the early nineteen-thirties, requiring the retention of collateral would seem likely to have been attended by consequences at least as serious to the creditor as requiring these respondents to continue to honor checks. Order No. 1 plainly contemplates the continuation of the normal functioning of the debtor's operational bank-accounts, including deposits as well as

withdrawals, in the ordinary course of business. The banks' "security" would not necessarily be significantly impaired.

Be that as it may, it is inconceivable that Congress intended that a railroad under section 77 reorganization should be deprived of the use of its cash, by the very act of filing the reorganization petition. If the respondent banks are correct in their contention that this Court's Order No. 1 was invalid, no railroad could possibly reorganize under section 77.

It is equally obvious that any such order, if it is to be effective, must necessarily be entered *ex parte*. The case of *In re Chicago and Northwestern Ry. Co., Megan v. Continental Illinois National Bank & Trust Company of Chicago,* 86 F. 2d 508 (7th Cir. 1936) demonstrates the inadvisability of advance notice in such situations. There, a public announcement of impending insolvency made it possible for a bank to exercise its right of setoff before the reorganization petition was filed, and the court held that the propriety of such antecedent setoff could be determined only in plenary litigation.

Some of the respondent banks have argued that this Court lacks jurisdiction over them, since section 23(b) of the Act provides that ". . . suits by the receiver and the trustee shall be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been instituted, unless by consent of the defendant. . . ." However, section 77(a) confers upon the reorganization court ". . . exclusive jurisdiction of the debtor and its property wherever located. . . ." In my judgment, the choses in action represented by these bank-accounts were and are "property" of the debtor for purposes of section 77(a). Since they were in the actual or constructive possession of the debtor when the petition was filed, they were within the summary jurisdiction of this Court. *Harris v. Brundage Co.,* 305 U. S.

160 (1938); *May v. Henderson,* 268 U. S. 111 (1925); see generally: *Collier on Bankruptcy,* section 23.04[2] (14th Ed. 1969).

For the reasons discussed above, I am satisfied that Order No. 1 in these proceedings was and is valid,[1] and that, with respect to all alleged setoffs exercised by the respondents on or after June 22, 1970, the respondents are in violation of the Order. With respect to the setoff exercised by the National City Bank of Cleveland, Ohio, on June 20, 1970, it is apparent that no violation of the Order is properly chargeable; moreover, the existence of a substantial adverse claim renders inappropriate for summary disposition the question of the validity of that setoff. *In re Chicago and Northwestern Ry. Co., supra.*

The seriousness of the continuing violations of this Court's Order No. 1 cannot be over-emphasized. If all of the 142 depositories had attempted the same disregard of the express terms of the Order, the operation of railroad service by the debtor would have been impossible. Because of the overriding public interests involved, no further delay in compliance can be tolerated. Respondents' derelictions cannot be excused merely because most of the banks did comply with the injunction.

The petition of the debtor asks, *inter alia,* that the respondents be ordered forthwith to comply with Order No. 1. This will be done, but it should be noted that Order No. 1 was self-executing and has not been directly challenged or appealed. The further Order now entered does not detract from or postpone its effectiveness to support the imposition of sanctions for the existing violations. The most that can be said is that prompt compliance may have a mitigating effect in the determination of penalties. Because of the abbreviated nature of the hearing and argu-

1. For present purposes, I have assumed, without deciding, that invalidity of the Order would be a defense in contempt proceedings.

ment, which were directed principally to the underlying legal issues, the present record is inadequate for proper consideration of possible differentiation among the various respondents as to contumacy and imposition of sanctions. Accordingly, these questions will be held in abeyance for the time being, for later consideration in light of intervening conduct and a more complete record.

ORDER (NO. 24)

AND NOW, this 5th day of August, 1970, it is ORDERED that the respondents, viz: National City Bank of Cleveland Ohio, Citizens Fidelity Bank and Trust Company, Louisville, Kentucky, National Bank of Detroit, Michigan, Lincoln Rochester Trust Company, Rochester, New York, Marine Midland Grace Trust Company, New York City, Central Penn National Bank, Philadelphia, Pennsylvania, First National Bank of Maryland, Baltimore, Maryland, First Wisconsin National Bank of Milwaukee, Wisconsin, and Central Trust Company of Cincinnati, Ohio, be, and each of them hereby is, directed forthwith to comply with Order No. 1 of this Court in this proceeding by restoring to the account of the debtor all balances as the same existed on June 21, 1970, and by honoring the debtor's withdrawals, checks and vouchers to the full extent of funds on deposit (without prejudice, as set forth in paragraph 7 of said Order, as amended), and to certify to this Court within 48 hours after receipt of a copy of this Order the fact of compliance herewith.

The foregoing Order is entered without prejudice to the pending application of the debtor for a formal adjudication of contempt and the imposition of sanctions for violations of Order No. 1, all of which matters are held in abeyance until further Order of this Court.

JOHN P. FULLAM, *J.*